CLIENT UPDATE

JOBS ACT TITLE III CROWDFUNDING MOVES CLOSER TO REALITY

NEW YORK
Peter J. Loughran
pjloughran@debevoise.com

Paul M. Rodel
pmrodel@debevoise.com

Lee A. Schneider
lschneider@debevoise.com

Raj A. Vashi
ravashi@debevoise.com

On October 23, 2013, the SEC voted unanimously to propose Regulation Crowdfunding,[1] the rules related to the offer and sale of securities through crowdfunded private offerings, as set forth in Title III of the Jumpstart Our Business Startups ("JOBS") Act. FINRA then published its proposed rules governing the licensing and regulation of so-called "funding portals," a new type of limited-purpose regulated intermediary solely for these offerings. Crowdfunding itself is not new. Websites like Kickstarter and IndieGoGo help all sorts of businesses, organizations and people raise money through small individual contributions for an identifiable idea or business. Until the JOBS Act, however, crowdfunding could not be used to offer or sell securities to the general public. Issuers and intermediaries relying on Regulation Crowdfunding expect to further democratize investing in start-ups, because any investor, whether or not accredited, may invest in these securities.

To permit crowdfunding, JOBS Act Title III added two provisions to the Securities Act of 1933: (1) Section 4(a)(6), which creates a new exemption to allow issuers to use crowdfunding to offer and sell securities in unregistered offerings and (2) Section 4A, which requires certain disclosures to be made by crowdfunding issuers and sets forth requirements for crowdfunding intermediaries. Proposed

---

1 *See* Release No. 33-9470 (Oct. 22, 2013), available at http://www.sec.gov/rules/proposed/2013/33-9470.pdf (the "Crowdfunding Release")

Regulation Crowdfunding and the proposed FINRA rules would implement these statutory provisions and create the regulatory framework for crowdfunding. Both agencies have sought comment on all aspects of their proposed rules, which are due in early February.

WHO MAY BE A CROWDFUNDING INVESTOR?

Anyone. Offerings under Regulation Crowdfunding are private offerings, but there are no limitations on who may invest. While the SEC has already permitted crowdfunding-type offerings to accredited investors in the AngelList[2] and FunderClub[3] no-action letters, offerings under JOBS Act Title III and Regulation Crowdfunding are not exclusively for accredited investors.

WHO MAY BE A CROWDFUNDING ISSUER?

Many, though not all, US companies would be eligible to rely on the crowdfunding exemption from registration. Non-US companies, issuers that are already SEC reporting companies and both registered and exempt investment companies would not be eligible. Additionally, issuers with certain deficiencies would be ineligible, including (a) companies disqualified under Section 302(d) of the JOBS Act and Proposed Rule 503 (which includes, among other things, certain designated "bad actor" disqualifications), (b) previous crowdfunding issuers that have failed to comply with the applicable annual reporting requirements during the two years prior to a new offering, (c) companies that have no specific business plan and (d) companies whose sole business plan is to engage in a merger or acquisition with one or more other companies.

HOW MUCH CAN AN ELIGIBLE ISSUER RAISE USING CROWDFUNDING?

An eligible crowdfunding issuer may raise a maximum of $1 million from all investors in a 12-month period. Only capital raised in reliance on the 4(a)(6) crowdfunding exemption will count towards this $1,000,000 limit; capital raised through other means, such as through a Regulation D offering, would not be counted in determining the aggregate amount sold in reliance on Section 4(a)(6). Furthermore, an offering made in reliance on Section 4(a)(6) would not be integrated with any other exempt offerings made by the issuer.

---

2 AngelList LLC, SEC No-Action Letter (Mar. 28, 2013), available at http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf.

3 FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (Mar. 26, 2013), available at http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf.

HOW MUCH CAN AN INVESTOR INVEST INITIALLY AND SELL IN SECONDARY TRANSACTIONS?

During the trailing 12 months preceding any crowdfunded transaction, an investor may invest no more than: (i) the greater of $2,000 and 5 percent of its annual income or net worth, as applicable, if both the annual income and net worth of the investor is less than $100,000; or (ii) 10 percent of its annual income or net worth, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or the net worth of the investor exceeds $100,000 (Proposed Rule 100(a)(2)). The SEC interpreted these investment limitations to apply to all investors, including retail investors (whether or not accredited) and institutional investors, and both U.S. and non-U.S. citizens or residents.

The statute and proposed rules also restrict sales and transfers of crowdfund-issued securities during the first year after issuance (Proposed Rule 501). There are exceptions for sales and transfers to the issuer, accredited investors and family members or as part of a public offering. Regulation Crowdfunding would not impose on intermediaries a verification requirement with respect to secondary transactions.

WHO MAY INTERMEDIATE A CROWDFUNDING OFFERING?

Section 4A permits two types of intermediaries for a crowdfunding offering: a registered broker-dealer and a new type of regulated entity called a "funding portal." The issuer may use only one intermediary in connection with its offering. Broker-dealers do not need to make special or additional filings in order to engage in crowdfunding offerings, but their activities in this area are governed by Regulation Crowdfunding. Funding portals must register with both the SEC and FINRA. FINRA has already proposed rules governing the registration and activities of funding portals, which would treat funding portals as a lighter version of a broker-dealer.

Based on the proposed rules from both the SEC and FINRA, funding portals are permitted to function only in a limited capacity, and as a result will be subject to somewhat relaxed versions of broker-dealer regulatory requirements, including registration with the SEC and FINRA, reporting of disciplinary and other actions, a "just and equitable principles of trade" standard in their dealings with customers and others, the establishment and maintenance of a supervisory structure, compliance with anti-money laundering rules and maintenance of a fidelity bond and certain books and records.

WHY IS THE INTERMEDIARY PROHIBITED FROM OWNING THE ISSUER?

Regulation Crowdfunding would broadly prohibit any direct or indirect ownership of the issuer by the intermediary or any of its officers, directors or partners. The prohibition would include any interest that is purely economic or financial in nature. It also would forbid the receipt of such an interest as compensation for intermediating the offering.

The SEC justified this rule on conflict of interest grounds, even though Title III limited the prohibition to just officers, directors and partners of the intermediary. It is unclear if the proposed rule would prevent the intermediary and the covered persons from co-investing in the crowdfunding offering on the same terms as other investors.

WHAT DISCLOSURES MUST THE ISSUER MAKE AND WHEN?

An issuer wishing to avail itself of Section 4(a)(6) and Regulation Crowdfunding must file specified disclosures with the SEC and provide these disclosures to investors and the relevant intermediary for dissemination to investors by posting on its platform. These disclosures would include:

- the issuer's name, legal status, physical address and website address;
- information about officers and directors as well as owners of 20 percent or more of the issuer;
- a description of the issuer's business, anticipated business plan, planned use of proceeds from the offering and financial condition;
- disclosure of the current number of employees, material terms of any indebtedness of the issuer and any exempt offerings conducted within the past three years;
- the proposed public offering price, target offering amount, deadline to reach the target amount and whether the company will accept investments in excess of the target amount;
- disclosures concerning certain types of related-party transactions;
- a description of the issuer's ownership and capital structure;
- financial statements of the company;[4]
- information about the intermediary, including its compensation;

---

[4] The financial statements must be reviewed by an independent accountant if the total amount raised is between $100,000 and $500,0000, and must be audited if the total amount raised is over $500,000.

- a discussion of the material risks associated with the investment; and
- certain mandatory legends.

The intermediary must make available these issuer disclosures for at least 21 days prior to the first securities being sold, but the intermediary may accept indications of interest during this period. While it is unclear whether the issuer can make changes to its disclosures during this 21-day period, the issuer must timely amend its offering document(s) to reflect material changes and provide updates on its progress toward reaching the target offering amount. A final update to investors disclosing the total amount of securities sold in the offering must occur no later than five days after the closing.

In addition to disclosures during the offering, issuers of successful crowdfunding offerings would be required to file an annual report with the SEC and provide it to investors. These annual reports require similar disclosures to the information provided in connection with the offering, but much less than is required of a public company. The SEC expects the issuer to determine how best to convey the information.

Regulation Crowdfunding would require that issuers meet their SEC filing requirements by submitting newly created Form C through EDGAR. Form C is designed to be flexible enough to meet the different disclosure and filing requirements by checking appropriate boxes and only filling in the applicable information.

The SEC has proposed a safe harbor for issuers for, among other things, insignificant failures to comply with Regulation Crowdfunding and good faith attempts to comply that fall short. While the safe harbor protects the offering (i.e., the issuer would not be required to become a public company), an enforcement action may nevertheless be commenced.

WHAT ARE THE INTERMEDIARY'S BASIC OBLIGATIONS?

Whether the intermediary is a broker-dealer or a funding portal, its basic obligations in connection with each offering are as follows:

- Provide an internet platform to facilitate the offering, including the making of applicable disclosures, and that includes a communication channel pursuant to which potential investors and others may discuss the offering;
- Take measures to reduce the risk of fraud by an issuer, including conducting due diligence concerning the issuer and its offering and denying access to issuers who are disqualified or present the potential for fraud;

- Open an account for each investor, and provide investors with educational materials, confirmations of investment commitments and purchases, and notifications of various events such as cancellation of the offering; and
- Arrange for the transmission of funds and securities, as applicable, in connection with the closing (or cancellation) of the offering.[5]

Proposed Rule 502 provides a safe harbor to issuers in the event of failures by the intermediary, so long as the issuer was not aware of such non-compliance or the failure occurred with respect to the offering of another issuer.

WHAT ADVERTISING OF THE OFFERING CAN OCCUR?

An issuer generally may not advertise the terms of the offering, except through the intermediary's platform. However, issuers may utilize a notice containing the terms of the offering, basic factual information about the issuer and the internet address of the intermediary's platform for further information and an opportunity to invest. There does not appear to be any limitation on how the issuer can make available this notice. If the issuer's chosen intermediary is a funding portal, the funding portal also may not advertise the offering, but can advertise its services as an intermediary in crowdfunding transactions and identify one or more issuers or offerings available on its platform.

The issuer and its employees may participate in any discussion forum or other similar communication channel on the platform so long as it identifies itself as an issuer. In fact, intermediaries are required to have such a communications mechanism on their platforms and make it available in all offerings. Additionally, the issuer can utilize (and compensate) promoters to participate through the communications channel, so long as the promoter identifies itself as such and discloses that it has or will earn compensation for its efforts.

WHO CAN PAY AND RECEIVE COMPENSATION IN CONNECTION WITH OFFERINGS?

The proposed rules would place various limitations on the payment and receipt of compensation in connection with a crowdfunding offering. The restrictions can depend on the identity of the payor, the recipient or both. Several of the key points about compensation are as follows:

- Issuers may compensate the intermediary for its participation in the offering, so long as that compensation does not include a financial interest in the issuer. The intermediary

---

[5] A broker-dealer intermediary may handle funds and securities on behalf of the issuer and/or investors, but a funding portal is prohibited from engaging in such activities.

must disclose to all investors who open accounts with it the manner in which it will be compensated in connection with an offering.

- Broker-dealer intermediaries may pay transaction-based compensation to appropriately registered persons (but not funding portals) for the referral of issuers and/or investors.
- Funding portals may compensate others for the referral (but not solicitation) of issuers and investors so long as the compensation is not transaction-based, unless the person it will pay is a registered broker-dealer.
- Funding portals may not compensate anyone for soliciting investors or prospects and may not pay transaction-based compensation to anyone.

WHAT ANTI-FRAUD AND CIVIL LIABILITY RULES APPLY TO THESE OFFERINGS?

Newly created Section 4A(c) of the Securities Act sets forth liability standards for issuers in connection with crowdfunding offerings. In the Crowdfunding Release, the SEC notes: "The anti-fraud and civil liability provisions of the Securities Act, such as Sections 12(a)(2) and 17, apply to exempted transactions, including those transactions that will be conducted in reliance on [crowdfunding]." Moreover, under JOBS Act Section 305(b), the securities enforcement authority of the states applies with respect to crowdfunding issuers, intermediaries and others relying on Section 4(a)(6).

CONCLUSION

As proposed, Regulation Crowdfunding may provide interesting fundraising possibilities for smaller issuers and commercial opportunities for crowdfunding platforms. As the comment process unfolds and the proposed rules are further refined, further questions are certain to arise.

* * *

Please do not hesitate to contact us with any questions.

November 18, 2013